

LESSON-15 PROVISIONS AND RESERVES

SUMMARY

A businessmen prepare their accounts on the basis of going concern concept assuming that their business will continue for an indefinite period. Hence, in order to ascertain the net profit for each year, businessmen need to take into account not only the current contingencies but future contingencies also. In fact, provisions and reserves are such considerations which actually relate to the future needs for which a part of the current earnings has to be set aside.

PROVISION : MEANING AND NEED

The events which are about to happen in the future are planned in the present with the help of available resources. In the same way these things are followed in a business also. When there are certain expected losses/ expenses, these are planned to be managed in advance from the current year's profits/ surplus. The amount which is kept separately to meet such expected losses/expenses is called a Provision.

Needs of Provision

i) Depreciation, renewal or reduction in the value of assets.

ii) A known liability, the amount of which cannot be determined with substantial accuracy.

iii) A disputed claim.

iv) Specific loss on realization of an asset or on payment of taxes.

v) Redeeming the liability.

vi) Writing off bad-debts/doubtful debts.

vii) Contingent liabilities.

General rules in creation of

Provisions

i) It is created by debiting the profit and loss account.

ii) It is created to meet a known liability or a specific contingency, e.g. 'Provision for bad and doubtful debts' and 'provision for depreciation' etc.

iii) A provision is created irrespective of whether there is profit or loss in the business.

iv) It is not available for distribution as dividend among shareholders.

v) A provision is made for a definite amount and, therefore, a definite sum is

set aside every year to meet the known contingency.

vi) Making of a provision is must to meet known liability or contingency.

vii) The provision is generally shown on the liability side of the balance sheet.

position of the company or for equalization of dividends etc.

iii) A reserve is created only when there is profit in the business.

iv) It can be distributed among shareholders as dividend.

MEANING OF RESERVE

An amount which is kept aside from our current income to meet the unexpected happening in the future is the reserve.

v) The reserve debentures is created without taking into consideration the actual amount required except in the case of redemption of when a definite sum is set aside.

vi) Creation of reserve depends upon the financial policy of the business and discretion of its management.

vii) It is usually shown on the liability side of the balance sheet as it is not a specific reserve.

TYPES OF RESERVES

- General Reserve
- Capital Reserve
- Secret Reserve
- Revenue Reserve
- Specific Reserve
- Reserve Fund
- Sinking Fund

General rules in creation of Reserves

i) It is created by debiting the profit and loss appropriation account.

ii) It is created to meet an unknown liability, or to strengthen the financial

ACTIVITY

Your parents from their regular income make some savings for the known or unknown expenses/liability to meet out in future. Prepare a list of past three months savings with reasons and differentiate them in reserves or provisions keeping in view the principles of the same, so that you may be clear about the term reserve & provisions.